

THE WESTERLY HOSPITAL AND SUBSIDIARY
(A Controlled Affiliate of Community Health of Westerly, Inc.)

SEPTEMBER 30, 2008

THE WESTERLY HOSPITAL AND SUBSIDIARY
(A Controlled Affiliate of Community Health of Westerly, Inc.)

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BlumShapiro

Independent Auditors' Report

The Board of Trustees
The Westerly Hospital and Subsidiary

We have audited the accompanying combined balance sheets of The Westerly Hospital and Subsidiary (the Hospital) (a controlled affiliate of Community Health of Westerly, Inc.) as of September 30, 2008 and 2007, and the related combined statements of operations and changes in net assets and cash flows for the years then ended. These combined financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Hospital's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of The Westerly Hospital and Subsidiary as of September 30, 2008 and 2007, and the results of their operations and changes in net assets and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Blum, Shapiro & Company, P.C.

January 19, 2009

THE WESTERLY HOSPITAL AND SUBSIDIARY
(A Controlled Affiliate of Community Health of Westerly, Inc.)

COMBINED BALANCE SHEETS

SEPTEMBER 30, 2008 AND 2007

ASSETS

	2008	2007
Current Assets		
Cash and cash equivalents	\$ 2,230,848	\$ 1,022,768
Patient accounts receivable, net	9,374,472	8,355,658
Inventories	1,407,604	1,322,590
Other current assets	986,201	740,155
Total current assets	<u>13,999,125</u>	<u>11,441,171</u>
Assets Limited as to Use		
Promises to give, net	193,000	-
By board to function as endowment	13,831,134	16,610,213
Under loan agreement, funds invested by trustee	1,896,451	1,820,886
By donors or grantors for specific purposes	332,708	187,158
By donors for permanent endowment funds	6,430,642	7,030,207
Funds held in trust	7,537,878	9,122,731
Total assets limited as to use	<u>30,221,813</u>	<u>34,771,195</u>
Other Assets		
Property, plant and equipment, net	38,852,580	40,056,703
Deferred financing costs, net	256,878	280,368
Due from related party, long-term	761,252	454,131
Other long-term assets	741,684	1,120,905
Total other assets	<u>40,612,394</u>	<u>41,912,107</u>
Total Assets	<u>\$ 84,833,332</u>	<u>\$ 88,124,473</u>

LIABILITIES AND NET ASSETS

	2008	2007
Current Liabilities		
Lines of credit	\$ 4,443,881	\$ 4,534,866
Current installments of long-term debt	872,374	838,274
Current installments of capital lease obligations	865,124	628,139
Accounts payable and accrued expenses	4,914,404	4,312,497
Deferred revenue	116,647	109,376
Accrued payroll, benefits and related taxes	4,347,748	3,775,110
Estimated third-party payor settlements	1,003,963	1,035,938
Total current liabilities	<u>16,564,141</u>	<u>15,234,200</u>
Long-Term Liabilities		
Long-term debt, net of current portion	14,688,880	15,554,989
Long-term portion of capital lease obligations	1,774,779	1,386,240
Noncurrent accrued pension cost	10,722,793	6,791,128
Asset retirement obligation	1,354,080	1,289,600
Total liabilities	<u>45,104,673</u>	<u>40,256,157</u>
Net Assets		
Unrestricted	25,234,433	31,528,219
Temporarily restricted	525,708	187,161
Permanently restricted	13,968,518	16,152,936
Total net assets	<u>39,728,659</u>	<u>47,868,316</u>
Total Liabilities and Net Assets	<u>\$ 84,833,332</u>	<u>\$ 88,124,473</u>

The accompanying notes are an integral part of the combined financial statements

THE WESTERLY HOSPITAL AND SUBSIDIARY
(A Controlled Affiliate of Community Health of Westerly, Inc.)

**COMBINED STATEMENTS OF OPERATIONS AND
CHANGES IN NET ASSETS**

FOR THE YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	<u>2008</u>	<u>2007</u>
Unrestricted Revenue		
Net patient revenue	\$ 80,841,956	\$ 71,960,443
Other revenue	1,429,041	1,208,778
Total revenues	<u>82,270,997</u>	<u>73,169,221</u>
Expenses		
Salaries and benefits	45,668,141	44,516,044
Supplies and other expenses	25,668,057	24,204,294
Depreciation	4,346,170	4,243,147
Provision for uncollectible accounts, net	6,263,526	4,641,222
Interest	1,423,608	1,545,280
Total expenses	<u>83,369,502</u>	<u>79,149,987</u>
Loss From Operations	<u>(1,098,505)</u>	<u>(5,980,766)</u>
Nonoperating Income		
Interest and investment income	429,902	3,402,498
Unrestricted gifts and bequests	1,180,103	863,736
Total nonoperating income	<u>1,610,005</u>	<u>4,266,234</u>
Excess (Deficiency) of Revenues and Gains over Expenses	511,500	(1,714,532)

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THE WESTERLY HOSPITAL AND SUBSIDIARY
(A Controlled Affiliate of Community Health of Westerly, Inc.)

**COMBINED STATEMENTS OF OPERATIONS AND
CHANGES IN NET ASSETS (CONTINUED)**

FOR THE YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	<u>2008</u>	<u>2007</u>
Other Changes in Unrestricted Net Assets		
Net assets released from restrictions for purchases of property and equipment	\$ -	\$ 87,982
Grant revenue - capital purchase	402,293	-
Capital transactions with affiliates	(735,600)	(115,842)
Change in unrealized losses on investments	(2,329,956)	(567,510)
Changes in additional minimum pension liability	(4,142,023)	(2,350,211)
Decrease in unrestricted net assets	<u>(6,293,786)</u>	<u>(4,660,113)</u>
Temporarily Restricted Net Assets		
Investment income	2,047	2,160
Gifts and bequests	143,500	90,119
Pledges	193,000	-
Net assets released from restrictions	-	(87,982)
Change in temporarily restricted net assets	<u>338,547</u>	<u>4,297</u>
Permanently Restricted Net Assets		
Net realized gains on investments	818,075	1,003,993
Net unrealized gains (losses) on investments	(3,002,493)	219,274
Gifts and bequests	-	767,583
Change in permanently restricted net assets	<u>(2,184,418)</u>	<u>1,990,850</u>
Change in Net Assets	(8,139,657)	(2,664,966)
Net Assets - Beginning of Year	<u>47,868,316</u>	<u>50,533,282</u>
Net Assets - End of Year	<u>\$ 39,728,659</u>	<u>\$ 47,868,316</u>

The accompanying notes are an integral part of the combined financial statements

THE WESTERLY HOSPITAL AND SUBSIDIARY
(A Controlled Affiliate of Community Health of Westerly, Inc.)
COMBINED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	<u>2008</u>	<u>2007</u>
Cash Flows from Operating Activities		
Change in net assets	\$ (8,139,657)	\$ (2,664,966)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation	4,346,170	4,243,147
Amortization	23,487	23,489
Contributions restricted for long-term investment	(143,500)	(857,702)
Provision for uncollectible accounts	6,263,526	4,641,222
Increase in additional minimum pension liability	4,142,023	2,350,211
Net realized and unrealized (gains) losses on permanently restricted investments	227,084	(1,223,267)
Net unrealized losses on unrestricted investments	4,287,290	567,510
Investment income and unrealized gains on temporarily restricted net assets	(2,047)	(2,160)
(Increase) decrease in operating assets:		
Patient accounts receivable	(7,282,340)	(3,851,889)
Inventories	(85,014)	237,721
Other assets	(246,046)	259,252
Promises to give	(193,000)	87,985
Due from related party	(307,121)	1,079
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	1,174,545	433,115
Deferred revenue	7,271	73,376
Accrued pension cost	(210,358)	(1,438,636)
Estimated third-party payor settlements	(31,975)	2,866
Asset retirement obligation	64,480	49,600
Net cash provided by operating activities	<u>3,894,818</u>	<u>2,931,953</u>
Cash Flows from Investing Activities		
Purchase of property, plant and equipment	(3,142,047)	(1,511,936)
Sale of investments, net	373,558	769,057
(Increase) decrease in other long-term assets, net	379,221	(651,078)
Net cash used in investing activities	<u>(2,389,268)</u>	<u>(1,393,957)</u>
Cash Flows from Financing Activities		
Repayments of long-term debt	(832,009)	(790,091)
Capital lease (repayments) borrowings	625,524	(615,700)
Line of credit (payments) borrowings	(90,985)	197,117
Net cash used in financing activities	<u>(297,470)</u>	<u>(1,208,674)</u>
Net Increase in Cash and Cash Equivalents	1,208,080	329,322
Cash and Cash Equivalents - Beginning of Year	<u>1,022,768</u>	<u>693,446</u>
Cash and Cash Equivalents - End of Year	<u>\$ 2,230,848</u>	<u>\$ 1,022,768</u>
Cash Paid During the Year for Interest	\$ 1,432,730	\$ 1,553,877

The accompanying notes are an integral part of the combined financial statements

THE WESTERLY HOSPITAL AND SUBSIDIARY
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NOTES TO COMBINED FINANCIAL STATEMENTS

Note 1 - Organization:

The Westerly Hospital and Subsidiary (the Hospital) is a not-for-profit acute care hospital under corporate governance of Community Health of Westerly, Incorporated (C.H.O.W.), a not-for-profit holding company. The Westerly Hospital Foundation (the Foundation) is a not-for-profit corporation formed to promote the charitable, educational and scientific purposes of the Hospital, under corporate governance of the Hospital. The Foundation is a subsidiary of the Hospital. Other affiliated entities under the corporate governance of C.H.O.W. include Mastuxet Realty, Inc., The Westerly Hospital Auxiliary, Inc., Women's Health of Westerly, LLC, Westerly Hospital Energy Co., LLC, and C.H.O.W. NewCo, Inc. Westerly Adult Day Services, Inc., disaffiliated itself from C.H.O.W. in 2008.

Note 2 - Summary of Significant Accounting Policies:

Basis of Presentation - The combined financial statements reflect the accounts of the Hospital and the Foundation and have been prepared on the accrual basis of accounting, in conformity with accounting principles generally accepted in the United States of America. All significant inter-company balances and transactions have been eliminated in combination.

The Hospital reports information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets and permanently restricted net assets.

Unrestricted Net Assets - Unrestricted net assets represent available resources other than donor-restricted contributions. These resources may be expended at the discretion of the Board of Directors.

Temporarily Restricted Net Assets - Temporarily restricted net assets represent contributions that are restricted by the donor as to purpose or time of expenditure. Temporarily restricted net assets are available for the following:

	<u>2008</u>	<u>2007</u>
Women's Initiative Campaign	\$ 193,000	\$ -
Charity care	7,854	7,834
Physician education	74,915	74,457
Capital expenditures	243,500	100,000
Other	6,439	4,870
	<u>\$ 525,708</u>	<u>\$ 187,161</u>

Permanently Restricted Net Assets - Permanently restricted net assets represent resources that have donor-imposed restrictions that require that the principal be maintained in perpetuity but permit the Hospital to expend a portion of the income earned thereon for general operating purposes. Such assets are primarily included in the Hospital's endowment funds. The Hospital is limited to distribution of realized and unrealized appreciation in excess of adjusted historical value, along with dividends and interest. When the fair value of permanently restricted funds is less than adjusted historical value, the Hospital is limited to distributions of dividends and interest.

Funds Held in Trust by Others - The Hospital is the sole beneficiary of the income from the Louise D. Hoxsey Foundation and the Estate of Charles A. Morgan trusts, which are held in perpetuity by an independent trustee. These trusts are recorded at market value and are included in assets limited as to use and permanently restricted net assets. The income from the Hoxsey trust is unrestricted, and Morgan trust income is restricted for charity care.

Annual distributions from the trusts are reported as other revenue that increases unrestricted net assets. Adjustments to the amounts reported as assets are recognized as permanently restricted gains or losses.

Income Taxes - The Hospital and the Foundation are organizations as described in Section 501(c)(3) of the Internal Revenue Code and are generally exempt from federal income taxes on related income under the Code.

Excess of Expenses over Revenues and Gains - The combined statements of operations and changes in unrestricted net assets include excess of expenses over revenues and gains. Changes in unrestricted net assets which are excluded from excess of expenses over revenues and gains, consistent with industry practice, include unrealized gains and losses on investments and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets, capital transactions with C.H.O.W. and affiliated entities, grants for capital expenditures and changes in additional minimum pension liability).

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include contractual allowances on patient revenue and the reserve for uncollectible accounts. Actual results could differ from those estimates.

Cash and Cash Equivalents - Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less, excluding amounts whose use is limited by donor designation or other arrangements under trust agreements that, at times, may exceed federally insured limits. In addition, cash equivalents may, at times, be invested in instruments not covered by federal insurance. The Hospital's deposits exceeded federal depository insurance limits as of September 30, 2008 and 2007. However, the Hospital has not experienced any losses in such accounts or instruments; and management believes the Hospital is not exposed to any significant credit risk on cash and cash equivalents.

Inventories - Inventories, consisting principally of supplies and pharmaceuticals, are stated at the lower of cost (first-in, first-out) or market.

Promises to Give - Unconditional promises to give cash and other assets to the Foundation are reported at fair value at the date the promise is received. Unconditional promises to give are reported as temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the combined statements of operations and changes in unrestricted net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying combined financial statements.

Investments - Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the combined balance sheets. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of expenses over revenues and gains unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of expenses over revenues and gains unless the investments are trading securities. None of the Hospital's investments are trading securities.

A decline in the market value of an investment security below its cost that is designated to be other than temporary is recognized through an impairment charge. The impairment charge is included in the excess of expenses over revenues and gains in the combined statements of operations and changes in unrestricted net assets, and a new cost basis is established.

Investment securities are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is possible that changes in the values of investment securities could occur in the near term and that such changes could materially affect the investment balances and activity reflected in the financial statements. Subsequent to September 30, 2008, the financial markets experienced significant volatility, including widespread declines in equity values. The Hospital maintains a diversified portfolio of investments and is actively monitoring the financial markets. The long-term impact of these events on the value of the Hospital's portfolio of investments is not known at this time.

Assets Limited as to Use - Assets limited as to use primarily include assets restricted by donors, assets held by trustees under indenture agreements and designated assets set aside by the board of trustees for future capital improvements, over which the board retains control and at its discretion may use for other purposes.

Property, Plant and Equipment - Property, plant and equipment acquisitions that individually exceed \$1,500 are recorded at cost. Depreciation is computed using the straight-line method based upon the estimated useful lives of the assets. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or estimated useful life of the equipment. Such amortization is included in depreciation in the combined financial statements. Maintenance and repairs are charged to expense as incurred, and renovations which extend the original expected life of the related assets are capitalized.

Gifts of long-lived assets such as land, buildings or equipment are reported as unrestricted support and are excluded from the excess of expenses over revenues and gains, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Without explicit donor

stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Deferred Financing Costs - Deferred financing costs are amortized over the lives of the related revenue bonds.

Net Patient Service Revenue - The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Restricted and Unrestricted Revenue and Support - Contributions received are recorded as unrestricted, temporarily restricted or permanently restricted support, depending on the existence and/or nature of any donor restrictions.

Support that is restricted by the donor is reported as an increase in unrestricted net assets if the restriction expires in the reporting period in which the support is recognized. All other donor-restricted support is reported as an increase in temporarily or permanently restricted net assets, depending on the nature of the restriction. When a restriction expires (that is, when a stipulated time restriction ends or purpose restriction is accomplished), temporarily restricted net assets are reclassified to unrestricted net assets and reported in the combined statements of operations and changes in unrestricted net assets as net assets released from restrictions.

The Hospital is incorporated under the laws of the State of Rhode Island and is, therefore, subject to the provisions of the Uniform Management of Institutional Funds Act (the Act), as amended. Under the Act, the original historic dollar value of a permanently restricted fund is prudently adjusted from time to time to reflect the change in the purchasing power of the fund. The accumulated realized and unrealized gains in excess of the adjusted historical dollar value related to the investment of a permanently restricted contribution may legally be appropriated for expenditure by the Hospital. Distributions of realized and unrealized gains cannot be made if those distributions would reduce the value of the assets in the fund below its historic value as adjusted, unless donor-imposed restrictions explicitly provide otherwise. Accordingly, the net gains on permanently restricted contributions which contain donor restrictions as to the use of income derived therefrom have been included in temporarily restricted net assets to the extent they are not spent pursuant to the restrictions in the same period they are earned. During the year, permanently restricted funds decreased by \$671,800 due to market performance. As such, only dividends and interest were withdrawn from permanently restricted funds. Future distributions from permanently restricted funds will be limited to interest and dividend income until the fair value of the assets in the funds equals the adjusted historic dollar value of the funds.

Assessments - During 2008 and 2007, the State of Rhode Island assessed a licensing fee to all Rhode Island hospitals based on each hospital's gross patient revenue. The licensing fee expense included in supplies and other expenses in the accompanying combined statements of operations and changes in unrestricted net assets was \$2,182,550 and \$2,208,592 for 2008 and 2007, respectively.

Malpractice Insurance Coverage and Estimated Malpractice Costs - The Hospital maintains its malpractice coverage on a claims-made basis and has renewed its policy for fiscal year 2009. The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Charity Care and Provision for Bad Debts - The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as revenue.

The Hospital grants credit without collateral to patients, most of whom are local residents and are insured under third-party arrangements. Additions to the allowance for uncollectible accounts are made by means of the provision for bad debts. Accounts written off as uncollectible are deducted from the allowance and subsequent recoveries are added. The amount of the provision for bad debts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in federal and state governmental healthcare coverage and other collection indicators.

Nonoperating Gains and Losses - The Hospital records unrestricted investment income from endowment funds and board-designated assets as nonoperating gains within the combined statements of operations and changes in unrestricted net assets. All gifts and grants are considered to be available for general use, unless specifically restricted by the donor, and are recorded at fair market value at the date received.

Donated Services - A substantial number of unpaid volunteers have made significant contributions of their time to the Hospital's programs and supporting services. These contributed services are not recorded as contributions in the combined financial statements.

State Unemployment Compensation Method - The Hospital uses the self-insurance method for unemployment insurance under which the Hospital reimburses the State of Rhode Island for actual unemployment benefits paid by the State.

Fair Value of Financial Instruments - The carrying amounts recorded in the combined balance sheets for cash and cash equivalents, patient accounts receivable, assets limited as to use, investments, accounts payable, accrued expenses and estimated third-party payor settlements approximate their respective fair values. The estimated fair value of the Hospital's long-term debt is disclosed in Note 10.

Asset Retirement Obligations - Statement on Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations*, as interpreted by the Financial Accounting Standards Board (FASB) Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations - an Interpretation of FASB Statement No. 143*, requires that a liability be recognized for an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be made. Certain of the Hospital's pipe coverings and floor tiles contain asbestos that must be removed upon demolition or upon extensive renovation. An asset retirement obligation of \$1,354,080 and \$1,289,600 has been included on the accompanying combined balance sheets as of September 30, 2008 and 2007, respectively. Accretion expense of \$64,480 was recognized by the Hospital during 2008. The Hospital expects to, and has the ability to, continue to maintain and operate its remaining buildings without undertaking any activities that would require removal of the asbestos.

Note 3 - **Charity Care:**

The Hospital maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges foregone for services and supplies furnished under its charity care policy, the estimated cost of those services and supplies, and equivalent service statistics. The following information summarizes charity care provided during the years ended September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Charges Foregone, Based on Established Rates	\$ 1,231,016	\$ 1,334,352

The Hospital also subsidizes the cost of treating patients who are on government assistance where reimbursement is below cost.

Note 4 - **Net Patient Service Revenue:**

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

Medicare - Inpatient acute care and certain outpatient services rendered to Medicare program beneficiaries are reimbursed at prospectively determined rates. Inpatient rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Payments for outpatient services are based on ambulatory payment classifications.

The Hospital is paid for certain cost reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare fiscal intermediary. The Hospital's classification of patients under the Medicare Prospective Payment System and the appropriateness of their admissions are subject to an independent review by a peer review organization under contract with the Medicare program. The Hospital's Medicare cost reports have been audited by the Medicare fiscal intermediary through September 30, 2006.

Blue Cross - Beginning in fiscal 1996, the Hospital is reimbursed at prospectively determined rates for inpatient services provided to Blue Cross patients based on per diem rates. Outpatient services are reimbursed in accordance with a negotiated fee assigned to respective revenue codes.

Medicaid - The Hospital is reimbursed for charges to Medicaid patients under the terms of a prospective rating contract. Under the contract, reimbursement rates are determined in advance based on budgeted costs and anticipated patient care statistics for the applicable year, as negotiated and agreed to by the third-party contractual agencies. Adjustments to anticipated patient care statistics are made at year end in accordance with provisions in the contract which recognize actual volume and intensity statistics. Settlements have been reached with Medicaid through September 30, 2004.

United Health Plans of New England, Inc. - The Hospital is reimbursed for inpatient services provided to United Health patients on a negotiated per diem rate. Outpatient services are reimbursed in accordance with a predetermined fee schedule.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Compliance with laws and regulations can be subject to future government review and interpretation as well as significant regulatory action; failure to comply with such laws and regulations can result in fines, penalties and exclusion from the Medicare and Medicaid programs. The Hospital believes it is in compliance with all applicable laws and regulations.

Note 5 - Other Revenue:

Other revenue for the years ended September 30, 2008 and 2007, comprises the following:

	<u>2008</u>	<u>2007</u>
Morgan trust income	\$ 344,935	\$ 313,782
Cafeteria sales	195,657	190,970
Pharmacy sales	366	617
Rental income and service fees	<u>888,083</u>	<u>703,409</u>
	<u>\$ 1,429,041</u>	<u>\$ 1,208,778</u>

Note 6 - Patient Accounts Receivable:

Accounts receivable are presented in the combined balance sheets net of an allowance for doubtful accounts of approximately \$5,011,000 and \$4,502,000 at September 30, 2008 and 2007, respectively. The Hospital provided \$6,263,526 and \$4,641,222 for uncollectible patient accounts during the years ended September 30, 2008 and 2007, respectively. Recoveries of approximately \$2,200,000 and \$1,022,000 were netted against the provision for uncollectible accounts for the years ended September 30, 2008 and 2007, respectively.

Note 7 - Promises to Give:

Unconditional promises to give are classified as temporarily restricted until such restriction is met. At September 30, 2008, unconditional promises to give are as follows:

Receivable in less than one year	\$ 210,920
Receivable in one to five years	<u>4,000</u>
Total unconditional promises to give	214,920
Less discounts to net present value using a risk-free rate of return of 4.8% and allowance for uncollectible promises receivable	<u>21,920</u>
Net Unconditional Promises to Give	<u>\$ 193,000</u>

Of the promises to give, \$150,000 are due from The Westerly Hospital Auxiliary, Inc., a related party.

Note 8 - **Investments**:

The following information is presented as of September 30, 2008 and 2007, regarding assets whose use is restricted by donors or limited by the board:

	<u>2008</u>	<u>2007</u>
Cash and short-term investments	\$ 3,431,917	\$ 1,780,084
Marketable equity securities	11,048,262	16,444,194
Other investments, primarily bonds	<u>6,114,305</u>	<u>5,603,300</u>
	<u>\$ 20,594,484</u>	<u>\$ 23,827,578</u>

The following information is presented as of September 30, 2008 and 2007, regarding assets invested by trustee under loan agreement:

	<u>2008</u>	<u>2007</u>
Cash and short-term investments	\$ 1,297,349	\$ 1,238,472
Other investments, primarily bonds	<u>599,102</u>	<u>582,414</u>
	<u>\$ 1,896,451</u>	<u>\$ 1,820,886</u>

The following information is presented as of September 30, 2008 and 2007, regarding assets held in trust:

	<u>2008</u>	<u>2007</u>
Cash and short-term investments	\$ 330,646	\$ 144,507
Marketable equity securities	4,173,915	6,449,631
Other investments, primarily bonds	<u>3,033,317</u>	<u>2,528,593</u>
	<u>\$ 7,537,878</u>	<u>\$ 9,122,731</u>

Included in interest and investment income is an investment impairment charge totaling \$108,766 and \$64,480 for the years ended September 30, 2008 and 2007, respectively, to reflect other than temporary declines in the fair market value of certain equity securities.

Investment income is stated net of management fees and expenses, which were \$75,535 and \$76,169 for the years ended September 30, 2008 and 2007, respectively.

At September 30, 2008, investments with market value below cost for 12 months or more included certain equity and bond securities with a market value of \$1,454,894 and \$572,701, respectively, and an unrealized loss of \$835,130 and \$19,322, respectively. Investments with market value below cost for less than 12 months at September 30, 2008 included certain equity and bond securities with a market value of \$5,894,797 and \$2,698,674, respectively, and an unrealized loss of \$1,390,801 and \$40,309, respectively.

Note 9 - **Property, Plant and Equipment:**

Property, plant and equipment at September 30, 2008 and 2007, comprises the following:

	<u>2008</u>	<u>2007</u>
Land and land improvements	\$ 2,428,957	\$ 2,286,849
Building and building improvements	43,510,583	43,147,814
Equipment	59,315,502	56,740,773
Construction in progress	63,135	25,913
	<u>105,318,177</u>	<u>102,201,349</u>
Less accumulated depreciation and amortization	<u>66,465,597</u>	<u>62,144,646</u>
Net Property and Equipment	<u>\$ 38,852,580</u>	<u>\$ 40,056,703</u>

Note 10 - **Long-Term Debt:**

The Hospital has a 6.25% secured promissory note payable in monthly installments of \$40,493 until June 15, 2014. After June 15, 2014, the interest rate will be adjusted to either 150 basis points greater than the bank's five- or ten-year cost of funds or the then 30-day LIBOR rate. It is the Hospital's option which rate to choose. The final payment is due June 15, 2024.

In January 1994, the Rhode Island Health and Educational Building Corporation issued \$20,485,000 of Hospital Financing Revenue Bonds - The Westerly Hospital Issue - Series 1994 (the Bonds) on behalf of the Hospital pursuant to the Loan and Trust Agreement dated January 15, 1994 (the Bond Agreement). The terms of the Bond Agreement stipulate that interest will be paid at rates between 2.75% and 6% per annum, with semiannual principal installment payments commencing July 1, 1994 and through July 1, 2019.

The terms of the Bond Agreement require that the Hospital make quarterly deposits to the trustee which are sufficient to provide for the payment of principal and interest due on the bonds. Such deposits are included in assets limited as to use. The Bond Agreement also requires the Hospital to maintain a certain debt coverage ratio. The Hospital is in compliance with its debt coverage ratio at September 30, 2008.

Long-term debt is comprised of the following at September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
6.25% secured promissory note, principal maturing June 15, 2024, monthly installments are \$40,493, interest is 6.25% until June 15, 2014	\$ 4,833,641	\$ 5,006,437
Series 1994 Tax-Exempt Revenue Bonds, principal maturing in varying annual amounts, due July 1, 2019, collateralized by a lien on certain equipment	9,980,000	10,610,000
7.72% mortgage loan, payable in monthly installments of \$6,274, including interest, collateralized by a mortgage on certain property	747,613	763,538
9.75% mortgage loan, payable in monthly installments of \$1,167, including interest, due September 19, 2008 collateralized by a mortgage on certain property	-	13,288
	<u>15,561,254</u>	<u>16,393,263</u>
Less current installments	<u>872,374</u>	<u>838,274</u>
Total Long-Term Debt	<u>\$ 14,688,880</u>	<u>\$ 15,554,989</u>

The aggregate maturities of long-term debt for the next five years and thereafter are as follows:

Year Ending September 30

2009	\$ 872,374
2010	925,998
2011	985,521
2012	1,046,002
2013	1,107,507
Thereafter	<u>10,623,852</u>
	<u>\$ 15,561,254</u>

The estimated fair market value of the Hospital's long-term debt at September 30, 2008 is approximately \$15,600,000, estimated using discounted cash flow analysis, based on current incremental borrowing rates for similar types of borrowing arrangements.

The Hospital has a \$3,500,000 secured line-of-credit agreement with a bank as of September 30, 2008 and 2007. The Hospital borrowed \$3,259,066 against the line of credit as of September 30, 2008 and 2007. Interest is payable on the outstanding balance at 150 basis points in excess of the 30-day LIBOR rate. Interest was 5.22% and 7.17% at September 30, 2008 and 2007, respectively. This line-of-credit agreement expires on January 1, 2011.

The Hospital has a \$1,500,000 secured line-of-credit agreement with a bank as of September 30, 2008 and 2007. The Hospital borrowed \$1,184,815 and \$1,275,799 against the line of credit as of September 30, 2008 and 2007, respectively. Interest is payable on the outstanding balance at 150 basis points in excess of the 30-day LIBOR rate. Interest was 5.22% and 7.17% at September 30, 2008 and 2007, respectively. This line-of-credit agreement expires March 1, 2009.

Approximately \$10,800,000 in investments collateralizes the promissory note and the two lines of credit.

Note 11 - Leases - Capital:

The Hospital leases various equipment under capital leases. The present value of future minimum capital lease payments is as follows:

Year Ending September 30

2009	\$ 1,010,624
2010	835,714
2011	651,516
2012	333,202
2013	109,749
Total minimum lease payments	2,940,805
Less amount representing interest at interest rates ranging from 5.51% to 9.14%	(300,902)
Present value of net minimum capital lease payments	2,639,903
Less current portion of capital lease obligations	(865,124)
Long-Term Capital Lease Obligations	<u>\$ 1,774,779</u>

The net book value of equipment under capital lease obligations is \$3,170,063.

Note 12 - Pension Plan:

The Hospital sponsors a noncontributory defined benefit retirement plan covering substantially all employees called The Westerly Hospital Retirement Plan (the Plan). The Plan provides pension benefits, which are based on years of service and compensation throughout the term of employment, and certain death benefits. It is the Hospital's policy to fund the minimum allowed contribution, taking into effect the IRS full-funding limitation. Contributions are intended to provide not only for benefits attributed to service to date, but also for those expected to be earned in the future.

In November 2006, the Plan was amended such that new employees hired after January 30, 2007 will not be eligible to participate in the Plan. New employees hired after that date will receive a 5% contribution to the Tax Sheltered Annuity Plan (TSA) once qualified under such plan. Existing employees (and those hired before January 30, 2007) will remain in (or eligible for) the Plan and will be eligible for a 1% match under the TSA once qualified under such plan. Existing employees may elect to transfer from the Plan to the TSA and receive an employer contribution of 5% of their salary once qualified under the Plan.

The FASB has issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an Amendment of FASB Statements No. 87, 88, 106, and 132R* (the Statement). The Statement requires companies to record a liability on the statements of financial position for the underfunded portion of its postretirement plans, defined as the amount by which the projected benefit obligation exceeds the fair value of plan assets. Management adopted the Statement in 2007, which resulted in an additional expense of \$5,854,393.

The following table sets forth the Plan's funded status and amounts recognized in the Hospital's combined financial statements at September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Change in benefit obligation:		
Projected benefit obligation at beginning of year	\$ 40,265,227	\$ 39,424,524
Service cost	1,648,403	1,629,398
Interest cost	2,499,959	2,301,992
Benefits paid	(1,175,124)	(1,080,967)
Actuarial gain	<u>(2,646,074)</u>	<u>(2,009,720)</u>
Projected Benefit Obligation at End of Year	<u>\$ 40,592,391</u>	<u>\$ 40,265,227</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	\$ 33,474,099	\$ 27,572,040
Actual return on plan assets	(4,258,620)	3,797,444
Contributions and transfers	1,829,243	3,185,582
Benefits paid	<u>(1,175,124)</u>	<u>(1,080,967)</u>
Fair Value of Plan Assets at End of Year	<u>\$ 29,869,598</u>	<u>\$ 33,474,099</u>
Accrued Pension Cost	<u>\$ 10,722,793</u>	<u>\$ 6,791,128</u>

The following table sets forth the unrecognized items impacting the Plan:

	<u>2008</u>	<u>2007</u>
Unrecognized loss from past experience different from that assumed and effects of changes in assumptions	\$ 12,607,342	\$ 8,544,312

The accumulated benefit obligation at the end of 2008 and 2007 was \$35,066,279 and \$34,370,834, respectively. The measurement dates are September 30, 2008 and 2007.

The following weighted average assumptions were used to determine end of year benefit obligations:

	<u>2008</u>	<u>2007</u>
Discount rate	6.75%	6.25%
Rate of compensation increase	4.50	4.50

Net periodic pension cost for 2008 and 2007 included the following components:

	<u>2008</u>	<u>2007</u>
Service cost - benefits earned during the period	\$ 1,648,403	\$ 1,629,398
Interest cost on projected benefit obligation	2,499,959	2,301,992
Expected return on assets	(2,792,678)	(2,304,717)
Recognized net actuarial loss	<u>342,194</u>	<u>551,063</u>
Net Periodic Pension Cost	<u>\$ 1,697,878</u>	<u>\$ 2,177,736</u>

The following weighted average assumptions were used to determine net periodic pension cost:

	<u>2008</u>	<u>2007</u>
Discount rate	6.25%	6.00%
Expected return on plan assets	8.50	8.50
Rate of compensation increase	4.50	4.50

The Hospital expects to contribute \$2,153,548 to the Plan during the upcoming year.

Expected benefit payments:

2009	\$ 1,408,126
2010	1,456,694
2011	1,554,771
2012	1,728,333
2013	2,059,533
2014-2018	13,230,797

The asset allocation for the Plan at the end of 2008 and 2007, and the target allocation for 2008 by asset category, are as follows:

<u>Asset Category</u>	<u>Target Allocation</u>	<u>Percentage of Plan Assets at</u>	
	<u>2008</u>	<u>2008</u>	<u>2007</u>
Equity	40-70%	54%	59.1%
Fixed income	30-60	37	33.3
Cash equivalents	0-10	9	7.6

The Hospital also provides an employer funded annuity plan covering substantially all employees. Hospital contributions to the annuity plan totaled \$235,138 and \$369,854 during 2008 and 2007, respectively.

Note 13 - Commitments and Contingencies:

The Hospital is presently a defendant in several pending medical malpractice and other suits. All of these suits are being defended by counsel of the Hospital's insurance carriers. In the opinion of the Hospital's management, any settlements or judgments of these suits will be covered by insurance and will have no significant adverse effect on the financial position or results of operations of the Hospital.

The Hospital is a guarantor on various lines of credit of certain physicians held by financial institutions. The Hospital provides this benefit through its recruitment process to attract physicians to the community. At September 30, 2008, there were no amounts outstanding on these lines of credit.

Note 14 - Leases:

Rental expense under all significant operating leases was \$779,372 and \$907,324 for the years ended September 30, 2008 and 2007, respectively. At September 30, 2008, future minimum lease payments under noncancelable operating leases are as follows:

Year Ending September 30

2009	\$ 779,372
2010	628,546
2011	277,651
2012	<u>71,800</u>
	<u>\$ 1,757,369</u>

Note 15 - Disproportionate Share:

The Federal government has long recognized the financial burdens which are borne by hospitals which serve an unusually large number or "disproportionate share" of low-income patients. The Hospital received disproportionate share payments of \$2,245,880 and \$2,541,895 for the years ended September 30, 2008 and 2007, respectively.

Note 16 - **Concentration of Credit Risk:**

The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. Revenues from patients and third-party payors were as follows:

	<u>2008</u>	<u>2007</u>
Medicare	37%	36%
Medicaid	2	1
Blue Cross	24	25
Other third-party payors	34	34
Patients	<u>3</u>	<u>4</u>
	<u>100%</u>	<u>100%</u>

Note 17 - **Related Parties:**

The following amounts were due to the Hospital from related parties at September 30, 2008:

C.H.O.W.	\$	52,357
Women's Health of Westerly, LLC		202,502
C.H.O.W. NewCo, Inc.		506,393

The Hospital also has employees working at Mystic Medical Office Building, Wood River Health Services, Urgent Care and Morgan Medical Building. None of these entities have amounts due to or from the Hospital at September 30, 2008.

Note 18 - **Functional Expenses:**

The Hospital provides general healthcare services to residents within its geographic location. Expenses related to providing these services are as follows:

	<u>2008</u>	<u>2007</u>
Healthcare services	\$ 52,059,014	\$ 51,329,245
Provision for uncollectible accounts	6,263,526	4,641,222
General and administrative	19,277,184	17,391,093
Interest	1,423,608	1,545,280
Depreciation and amortization	<u>4,346,170</u>	<u>4,243,147</u>
	<u>\$ 83,369,502</u>	<u>\$ 79,149,987</u>